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IN THE
Supreme Court of the United States
OCTOBER TERM, 1988

COLONIAL AMERICAN LIFE INSURANCE COMPANY,
Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

On Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

BRIEF FOR THE AMERICAN COUNCIL OF LIFE INSURANCE AND THE NATIONAL ASSOCIATION OF LIFE COMPANIES AS AMICI CURIAE IN SUPPORT OF PETITIONER

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BRIEF FOR THE AMERICAN COUNCIL OF LIFE INSURANCE AND THE NATIONAL ASSOCIATION OF LIFE COMPANIES AS AMICI CURIAE IN SUPPORT OF PETITIONER

This brief is submitted with the written consent of counsel to both parties filed with the Clerk of the Court.

INTEREST OF THE AMICI CURIAE

The American Council of Life Insurance ("ACLI") is a trade association with 646 life insurance company members. These member companies account for 93 percent of all the life insurance business in force in the United States and hold 93 percent of the total assets of

all United States life insurance companies. The National Association of Life Companies ("NALC") is a trade association with over 600 small and medium-sized life insurance company members, many of which are also members of the ACLI.

The issue in this case is whether a life insurance company is entitled to deduct currently, in computing its taxable income, the ceding commissions it incurs in issuing indemnity reinsurance to another life insurance company. As is explained in the argument, *infra*, indemnity reinsurance is essential to the operation of the life insurance business. Indemnity reinsurance enables all life insurance companies to distribute adequately their risks and small life insurance companies to grow and to compete with large life insurance companies.

Because of the vital role of indemnity reinsurance, member companies of the ACLI and the NALC regularly engage in indemnity reinsurance transactions. The treatment of ceding commissions affects not only the tax liability of the companies issuing indemnity reinsurance, but also the cost to companies obtaining the indemnity reinsurance coverage. Thus, the issue in this case is of major importance to the members of the ACLI and the NALC.

SUMMARY OF ARGUMENT

The initial expenses incurred by a life insurance company in issuing an insurance policy are deductible in the year those expenses are incurred. That result should not change when the insurance company is insuring another insurance company rather than members of the public. When a life insurance company causes a policy to be reinsured under an indemnity reinsurance contract, the reinsuring company issues insurance coverage to the original company, thereby insuring the original company for part of its risk under the original policy. The initial expenses incurred by the reinsuring company in issuing

its indemnity reinsurance contract to the original company include a payment to that company. This payment is known as a "ceding commission."

The initial expenses incurred by the original company in issuing its insurance policies are currently deductible. The reinsuring company also should be able to deduct currently its initial expenses, including its ceding commissions. The legislative history of the Life Insurance Company Income Tax Act of 1959, Pub. L. No. 86-69, 73 Stat. 112 (the "1959 Act"), reveals that Congress intended this treatment, and section 809(c)(1)[1] provides for it. The Commissioner's contention that ceding commissions paid by the reinsurer should not be deductible currently, but rather should be capitalized, reflects a lack of understanding of the nature and purpose of indemnity reinsurance as well as a failure to recognize the differences between indemnity reinsurance and assumption reinsurance. Furthermore, current deductibility of the initial expenses incurred by a reinsurer ensures, as Congress intended, that the Federal income tax treatment of indemnity reinsurance is neutral—companies are neither penalized nor rewarded by the tax system for obtaining indemnity reinsurance coverage.

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[1] Unless otherwise noted, all section references are to the Internal Revenue Code of 1954 (26 U.S.C. (1976)), as amended and in effect during 1975 and 1976. The provisions of part I of subchapter L of the Code, which govern the taxation of life insurance companies, were extensively amended by the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (the "1984 Act"). However, that legislation did not alter the substance of those provisions insofar as they pertain to the treatment of ceding commissions. Thus, this Court's decision will control the treatment of ceding commissions under current law as well as under prior law.

ARGUMENT

A LIFE INSURANCE COMPANY IS ENTITLED TO DEDUCT CURRENTLY THE CEDING COMMISSIONS IT INCURS IN ISSUING INDEMNITY REINSURANCE CONTRACTS

I. Introduction

A. *The Purpose of Indemnity Reinsurance*

When an insurance policy is issued, the policyholder is colloquially said to have "insurance" because he has shifted a risk from himself to the insurance company. However, insurance does not consist merely of shifting a risk. Rather, a fundamental part of the business of insurance is the spreading of the risks which have been shifted to the insurance company. It is to achieve this spreading of risks that a form of insurance known as *indemnity reinsurance* is continually employed by insurers.

Were a life insurance company to insure the life of only one person, the company simply would be betting on the life expectancy of that person. Insuring a large number of lives avoids this gamble. The reason for this is that the greater the number of lives insured, the less the actual number of deaths in the group in any given period will differ from the predicted number of deaths for that period. *See generally* K. Black, Jr. & H. Skipper, Jr., *Life Insurance* 13-14 (11th ed. rev. 1987). This spreading of risk through the insurance of a large number of persons is known as "risk distribution." *See Helvering v. LeGierse*, 312 U.S. 531 (1941).

Effective risk distribution requires not only a sufficiently large pool of insureds, but also limitations on the amount of risk that an insurance company accepts with respect to any one insured. This is because a life insurance company's risk with respect to an insured life is determined not only by the probability of death in any given period, but also by the amount of the death benefit it will pay. Every life insurance company, therefore, sets a limit on the maximum amount of coverage it can safely maintain with respect to any one insured. Steffen, "Reinsurance," in *Life and Health Insurance Handbook* 991, 992 (D. Gregg & V. Lucas eds., 3d ed. 1973); K. Black, Jr. & H. Skipper, Jr., *supra* p. 4, at 431. This limit is often referred to as the company's "retention" limit. A company's retention limit will depend in part on the overall size of the company. Generally speaking, a larger company will have a larger surplus than a smaller company and thus will have a greater ability to absorb unexpected fluctuations in mortality experience. Consequently, a larger life insurance company will generally have a higher retention limit than will a smaller company. *See* K. Black, Jr. & H. Skipper, Jr., *supra* p. 4, at 431.

Were this the end of the story, only large insurance companies would be able to write policies covering large risk amounts, and small companies would be relegated to writing small policies. In addition, some risk amounts might be so large that they would not be capable of coverage by any one company. It is indemnity reinsurance which prevents this from being the case.

Indemnity reinsurance is insurance coverage taken out by an insurance company on risks that it has originally insured. *See* K. Black, Jr. & H. Skipper, Jr., *supra* p. 4, at 431. By means of indemnity reinsurance, a company that issues insurance policies to the public (known as the "direct writer" or the "ceding company") can issue policies in the amounts desired and yet maintain an adequate distribution of risk. For example, a small life insurance company which has determined that it cannot safely carry a risk of more than $30,000 per insured may receive an application from an individual who desires coverage of $50,000. Through indemnity reinsurance, the company can nevertheless issue the $50,000 policy, retaining $30,000 of risk and insuring the remaining $20,000 of risk under an indemnity reinsurance contract. Thus, when the insured individual dies, al-

though the direct writer will pay the entire death benefit of $50,000, the reinsurer will pay the direct writer $20,000 under the indemnity reinsurance contract. *See* Rohm, *Life Reinsurance*, 5 Proc. Conf. Actuaries in Pub. Prac. 100, 103-04 (1956).

While the primary purpose of indemnity reinsurance is to achieve adequate risk distribution and thereby prevent the concentration of too much risk in one company, indemnity reinsurance also serves other purposes. Indemnity reinsurance often is used to reduce the drain on a company's surplus caused by writing new business, thereby allowing small and growing life insurance companies to continue issuing insurance. *See United States v. Consumer Life Ins. Co.*, 430 U.S. 725, 737-38 (1977) (explaining the use of reinsurance to reduce surplus drain). In addition, indemnity reinsurance helps to stabilize the mortality experience of the ceding company. *See* K. Black, Jr. & H. Skipper, Jr., *supra* p. 4, at 431 (discussing the uses of indemnity reinsurance).

In short, indemnity reinsurance is essential to the operation of the insurance business. Because of its vital role, indemnity reinsurance occurs continually among life insurance companies. In 1987 alone, the life insurance industry reinsured $443 billion of life insurance coverage. A.M. Best Co., *Best's Aggregates and Averages: Life-Health* 49 (7th ed. 1988).[2]

B. *The Operation of Indemnity Reinsurance*

In an indemnity reinsurance transaction, the direct writer buys insurance coverage from another insurance company, the reinsurer, on risks the direct writer has accepted under its policies. Kramer, "The Nature of Reinsurance," in *Reinsurance* 1, 5 (R. Strain ed. 1980). The indemnity reinsurance contract is a separate contract of insurance between the direct writer and the reinsurer. *See Merit Life Ins. Co. v. Commissioner*, 853 F.2d 1435, 1441 (7th Cir. 1988), *petition for cert. filed*, 57 U.S.L.W. 3434 (U.S. Dec. 8, 1988) (No. 88-955); *Oxford Life Ins. Co. v. United States*, 790 F.2d 1370, 1376 (9th Cir. 1986); *Cologne Life Reinsurance Co. v. Commissioner*, 80 T.C. 859, 862 (1983), *aff'd by summary order*, 732 F.2d 141 (2d Cir. 1984) (unpublished opinion); *Beneficial Life Ins. Co. v. Commissioner*, 79 T.C. 627, 646 (1982); Kramer, *supra* p. 6, at 4; K. Thompson, *Reinsurance* 4 (3d ed. 1951).

The indemnity reinsurance contract between the direct writer and the reinsurer is in addition to the original insurance contract between the ceding company and its policyholder; the indemnity reinsurance contract does not supplant or replace that original contract. Significantly, the indemnity reinsurer assumes *no* liability to the policyholders of the direct writer. *See, e.g., Merit Life*, 853 F.2d at 1436; *Lincoln Nat'l Life Ins. Co. v. United States*, 582 F.2d 579, 593 (Ct. Cl. 1978). In short, indemnity reinsurance is "insurance for the inurer." K. Black, Jr. & H. Skipper, Jr., *supra* p. 4, at 431.[3]

Although all indemnity reinsurance contracts share certain common characteristics, specific terms can vary considerably from one contract to another. For example, some indemnity reinsurance contracts may insure part of the direct writer's risks under insurance policies that the direct writer has already issued, other indemnity reinsurance contracts may insure risks only under policies to be issued by the direct writer in the future, and still other contracts may insure risks under both existing and future policies of the direct writer. *See generally* K. Black, Jr. & H. Skipper, Jr., *supra* p. 4, at 432-33 (dis-

[2] A precise identification of the portion of this reinsurance which is indemnity reinsurance is not possible. Given the purposes of indemnity reinsurance, however, amici believe that the preponderance is indemnity reinsurance.

[3] Indeed, some insurance companies, known as professional reinsurers, have a division or unit that specializes in such "insurance for the insurer." These professional reinsurers often obtain indemnity reinsurance from other reinsurers. Such a reinsurance contract between reinsurers is referred to as a retrocession. *See* Steffen, *supra* p. 5, at 1005.

cussing indemnity reinsurance arrangements). Indemnity reinsurance contracts also differ with respect to the basis on which the contract may be terminated in whole or in part. Like other insurance policies, an indemnity reinsurance contract frequently may be terminated at the instance of the insured party (the direct writer), subject to any restrictions or penalties to which the parties may have agreed. Tax Court Transcript at 39-40, *Colonial Am. Life Ins. Co. v. Commissioner*, 51 T.C.M. (CCH) 1123 (1986) (No. 20384-83).

The reinsurance contracts between petitioner Colonial American Life Insurance Company ("Colonial American"), the reinsurer, and Transport National Life Insurance Company ("Transport"), the direct writer and ceding company, involved two forms of indemnity reinsurance known as conventional coinsurance (or simply coinsurance) and modified coinsurance. *See Colonial Am. Life Ins. Co. v. Commissioner*, 843 F.2d 201, 202 (5th Cir. 1988).[4] In addition, a third type of indemnity reinsurance is generally recognized: yearly renewable term reinsurance. *See Steffen*, *supra* p. 5, 993-99; Rohm, *supra* p. 6, at 100.

C. *The Role of the Ceding Commission*

When a direct writer issues an insurance policy, it receives premium income from the policyholder. In issuing the policy, the direct writer incurs substantial initial expenses, including the selling agent's commission, medical underwriting costs, state premium taxes, and computer and other administrative costs. Likewise, when an indemnity reinsurer issues insurance coverage to a direct writer, the reinsurer receives premium income from

[4] Colonial American and Transport consented, pursuant to section 820 and Treas. Reg. § 1.820-2, to treat the modified coinsurance contracts in the same manner as the conventional coinsurance contracts for Federal income tax purposes. *Colonial Am. Life Ins. Co.*, 843 F.2d at 203. As a consequence of that election, the modified coinsurance contracts are treated the same as the conventional coinsurance contracts. *See Consumer Life Ins. Co.*, 430 U.S. at 747-49.

the direct writer and incurs substantial initial expenses, including an expense referred to in the insurance industry as a ceding commission.

The ceding commission incurred by an indemnity reinsurer in issuing an indemnity reinsurance contract to another insurance company is an initial expense that is analogous to the initial expenses that the direct writer incurs in issuing insurance policies to the public. *See Colonial Surety Co. v. United States*, 178 F. Supp. 600, 602 (Ct. Cl. 1959) (comparing ceding commissions paid by an indemnity reinsurer with agents' commissions paid by a direct writer). The reinsurer pays the ceding commission to the direct writer. The amount of the ceding commission is negotiated between the direct writer and the reinsurer, taking into account a number of elements. *See* Rev. Rul. 79-138, 1979-1 C.B. 359 (describing a ceding commission as being "based upon agents' commissions, premium taxes, license taxes, fees, and administrative and overhead expenses incurred by the [direct] insurer in underwriting the insurance plus a profit factor"); Rev. Rul. 82-69, 1982-1 C.B. 102 (describing a reinsurance contract in which the stated purpose of the ceding commission "was to reimburse [the direct writer] for agents' commissions and other expenses associated with selling and maintaining the reinsured policies that were incurred by [the direct writer] before the effective date of the reinsurance agreement"); Tax Court Transcript at 5, 33-34, 36-39, 50-51, *supra* p. 8 (describing ceding commissions as taking into account a variety of elements, including the expenses incurred by the direct writer and the anticipated profit to the reinsurer).

The role of the ceding commission in reimbursing the initial expenses incurred by the direct writer in issuing insurance contracts to its insureds has been recognized by this Court. *See Consumer Life Ins. Co.*, 430 U.S. at 746

(describing the ceding commission as an amount paid by the reinsurer "to cover the insurer's overhead.") Similarly, one commentator, while noting the various elements that are reflected in the ceding commission, has summarized its function in these terms:

> In summary, the economic function of reinsurance commissions may be described as follows: Basically, reinsurance commissions constitute a refund of the operating expenses incurred by the direct insurer for the business reinsured and usually included in the calculation of the original gross premium.

1 K. Gerathewohl, *Reinsurance Principles and Practices* 245 (1982); *see also* K. Thompson, *supra* p. 7, at 85 ("The theory behind the giving of a commission to the reassured is, of course, to help the reassured in his expenses, particularly in connection with the acquisition cost of the business.").

D. *Assumption Reinsurance Distinguished*

In contending that indemnity reinsurance ceding commissions should be capitalized, the Commissioner has for this purpose equated indemnity reinsurance with a sale transaction called "assumption reinsurance." *See, e.g.*, Brief for Appellant at 35-38, *Colonial Am. Life Ins. Co. v. Commissioner*, 843 F.2d 201 (5th Cir. 1988) (No. 87-4492). In its holding in this case, the Fifth Circuit Court of Appeals appears to have accepted the validity of this equation. *See Colonial Am. Life Ins. Co.*, 843 F.2d at 205. Amici respectfully submit that the Commissioner is wrong in equating indemnity reinsurance with assumption reinsurance. Assumption reinsurance is fundamentally different than indemnity reinsurance.

Indemnity reinsurance is the issuance of an insurance policy by one insurance company to another insurance company. Assumption reinsurance is the sale by one in-

surance company of its insurance policies to another insurance company.[5]

In an assumption reinsurance transaction, the buyer enters into a direct contractual relationship with the policyholders of the seller. Thus, the buyer assumes all obligations under the policies and becomes directly liable to the policyholders. Furthermore, after the sale, the seller is relieved of all liability to the policyholders involved. Such a transaction typically requires the consent of the policyholders and thus constitutes a novation. *See Merit Life*, 853 F.2d at 1436; Treas. Reg. § 1.809-5 (a)(7)(ii) (defining assumption reinsurance). *See generally* Kramer, *supra* p. 6, at 16-17 (describing the "special case" of assumption reinsurance, referred to therein as "portfolio reinsurance").

An assumption reinsurance transaction is recognized as a sale for both tax[6] and state regulatory accounting

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[5] In an assumption reinsurance transaction, an insurance company commonly agrees to sell all of its in-force insurance policies to another insurance company. *See* K. Black, Jr. & H. Skipper, Jr., *supra* p. 4, at 431 n.6; Steffen, *supra* p. 5, at 1003-4. In some cases, rather than disposing of its entire in-force business, the insurance company may sell either a line of business it no longer desires to write, *e.g.*, group term contracts, or policies in a certain geographic area in which it no longer desires to do business. *See* K. Black, Jr. & H. Skipper, Jr., *supra* p. 4, at 431 n.6.

[6] *See* Treas. Reg. § 1.817-4(d). The fundamental differences between indemnity and assumption reinsurance were recently reaffirmed in connection with the revisions made by Congress to Part I of Subchapter L in the 1984 Act:

> The Code distinguishes between indemnity reinsurance (or reinsurance ceded) and assumption reinsurance. The first is an arrangement whereby the ceding company remains solely liable to the policyholder, whether all or only a portion of the risk has been transferred to the reinsurer. The second is an arrangement whereby another person (the reinsurer) becomes solely liable to the policyholders on the contracts transferred by the ceding company. *Whereas an indemnity reinsurance contract describes a continuing insurance relationship between the*

purposes.[7] Its character as a sale is underscored by the fact that, unlike an indemnity reinsurance agreement, an assumption reinsurance agreement cannot be cancelled after it becomes effective.

Because assumption reinsurance entails a new insurance company replacing the original insurance company, regulatory approval, as well as the approval of the policyholders, is generally required before such a transfer can occur. *See* Kramer, *supra* p. 6, at 17. These requirements make assumption reinsurance transactions difficult to effectuate. Assumption reinsurance transactions are thus extraordinary, rather than ordinary, transactions in the life insurance business.

In sum, assumption reinsurance is not the issuance by one insurance company of a separate insurance contract to another insurance company, but rather involves one insurance company replacing another. In indemnity reinsurance, on the other hand, a separate contract of insurance is issued by one insurance company to another, and the policyholders of the reinsured policies are not parties. *See* Kramer, *supra* p. 6, at 6. Indeed, they rarely are aware of the existence of the indemnity reinsurance contract. In unequivocal terms, the Courts of

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ceding company and the reinsurer, an assumption reinsurance contract is considered a sale of a block of business.

Staff of Joint Comm. on Taxation, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 633 (Joint Comm. Print 1984) (emphasis added).

[7] In accordance with practices approved by the National Association of Insurance Commissioners ("NAIC"), when a group of policies is transferred in an assumption reinsurance transaction, all accounting for it is removed from the NAIC annual statement of the selling company. In contrast, the reserves for policies covered by indemnity reinsurance remain on the direct writer's annual statement, with credit being given for the reinsurance coverage that is in effect. *See* Nat'l Ass'n Ins. Commissioners, *Annual Statement Instructions: Life, Accident and Health* 10-1 (1984) (describing the treatment of indemnity reinsurance).

Appeals for the Seventh and Ninth Circuits, as well as the United States Tax Court, have recognized the essential distinction between indemnity reinsurance, on the one hand, and an assumption reinsurance transaction on the other. *Merit Life*, 853 F.2d at 1441; *Oxford Life*, 790 F.2d at 1376 & n.6; *Beneficial Life*, 79 T.C. at 636, 645-46. In the words of the Seventh Circuit Court of Appeals:

> By its nature, an indemnity reinsurance transaction is, from the perspective of the reinsurer . . . the sale of an insurance policy by the reinsurer to the ceding company. Economically, it is substantially the same as the sale of any other policy. In contrast, assumption reinsurance is by its nature the purchase of already issued insurance policies . . . .

Merit Life, 853 F.2d at 1441.

E. *Summary*

Indemnity reinsurance is insurance coverage issued by one insurance company, the reinsurer, to another, the direct writer. The reinsurer insures the direct writer for part of the risk the direct writer has accepted under insurance policies it has issued to the public. Indemnity reinsurance thus is issued through a separate insurance contract between the direct writer and the reinsurer. When an indemnity reinsurer issues an indemnity reinsurance contract, it incurs substantial initial expenses, including a ceding commission. The ceding commission is analogous to the initial expenses, such as agents' commissions, that a direct writer incurs in issuing its insurance policies. Indemnity reinsurance is continually issued as a necessary part of the life insurance business.

On the other hand, unlike indemnity reinsurance, an assumption reinsurance transaction is an extraordinary event involving the sale by one insurance company of some or all of its insurance policies to another insurance company. An assumption reinsurance transaction is

recognized not as the issuance of insurance coverage, but as the purchase of part or all of a life insurance business.

II. Indemnity Reinsurance Ceding Commissions Are Currently Deductible Expenses

A. *Ceding Commissions Are Initial Expenses of an Indemnity Reinsurer and Congress Intended Them to be Deductible Just as the Initial Expenses of a Direct Writer Are Deductible*

The ceding commission paid by a reinsurer under an indemnity reinsurance contract is an initial expense incurred in issuing an insurance contract, just as the agent's commission and other initial expenses of the direct writer are expenses incurred in issuing an insurance contract. The ceding commission serves the same purposes as the initial expenses of the direct writer. It is indisputable that the initial expenses of a direct writer are deductible when incurred.[8] Nevertheless, the Commissioner contends that a substantial portion of the initial expenses of the reinsurer, the ceding commissions, must be capitalized. Amici respectfully submit that the Commissioner's contention is wrong.

Both the direct writer's initial expenses and the indemnity reinsurer's ceding commissions are common, ordinary, day-to-day expenses of insurance companies issuing insurance contracts. As the Seventh Circuit Court of Appeals observed in holding that indemnity reinsurance ceding commissions are deductible:

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[8] *See, e.g.*, S. Prt. 169 (Vol. I), 98th Cong., 2d Sess. 555 (1984); H.R. Rep. No. 432 (Part II), 98th Cong., 2d Sess. 1428 (1984), *reprinted in* 1984 U.S. Code Cong. & Admin. News 697, 1073; S. Rep. No. 1428, 88th Cong., 2d Sess. 4 (1964), *reprinted in* 1964 U.S. Code Cong. & Admin. News 3586, 3590; H.R. Rep. No. 1412, 88th Cong., 2d Sess. 4 (1964), *reprinted in* 1964-2 C.B. 838, 840; S. Rep. No. 291, 86th Cong., 1st Sess. 7 (1959), *reprinted in* 1959 U.S. Code Cong. & Admin. News 1575, 1582; H.R. Rep. No. 34, 86th Cong., 1st Sess. 4 (1959), *reprinted in* 1959-2 C.B. 736, 738; *Beneficial Life*, 79 T.C. at 647; *Merit Life*, 853 F.2d at 1442.

> Whether or not an insurance company sells insurance to an individual or to another insurance company, each involves the issuance of new policies and the transfer of a risk and, under the Code, the commission expenses incurred in either transaction, whether paid to insurance agents in the case of individual policies or to ceding companies in the case of reinsurance, are deductible in the year of their payment.

Merit Life, 853 F.2d at 1442. The Tax Court has consistently held this view since it first considered the question seven years ago. *See Beneficial Life*, 79 T.C. 627; *Modern Sec. Life Ins. Co. v. Commissioner*, 51 T.C.M. (CCH) 188 (1985), *rev'd sub nom. Modern Am. Life Ins. Co.*, 818 F.2d 1386 (8th Cir. 1987); *Individual Life Assurance Co. v. Commissioner*, 51 T.C.M. (CCH) 1028 (1986), *revised per memorandum sur order* (Oct. 8, 1987); *Colonial Am. Life Ins. Co. v. Commissioner*, 51 T.C.M. (CCH) 1123 (1986), *rev'd*, 843 F.2d 201 (5th Cir. 1988); *Merit Life Ins. Co. v. Commissioner*, 52 T.C.M. (CCH) 658 (1986), *aff'd*, 853 F.2d 1435 (7th Cir. 1988), *petition for cert. filed*, 57 U.S.L.W. 3434 (U.S. Dec. 8, 1988) (No. 88-955).

The reasoning of the Seventh Circuit Court of Appeals and the Tax Court reflect the intent of Congress that indemnity reinsurance ceding commissions be treated in the same manner as other initial expenses incurred in issuing an insurance contract. That intent was expressed by Congress in enacting, as part of the 1959 Act, the provisions of the Internal Revenue Code that govern in this case. Specifically, the Report of the Senate Finance Committee stated:

> [C]oinsurance calls for the premium with respect to the insurance reinsured to go to the reinsurer, with the result that *the reinsurer, with respect to this insurance, is treated substantially in the manner he would be if he had issued the insurance policy (or part thereof) directly.* Any expenses incurred by the initial insurer with respect to the policy are

reimbursed by the reinsurer. This form of indemnity reinsurance presents few special tax problems. . . . .

[T]he bill . . . treats modified coinsurance in the same manner as conventional coinsurance; that is, *a policy to the extent reinsured in this manner generally is treated as if it were a policy issued by the reinsurer instead of the initial insurer.*

Thus, premiums, gross investment income, capital gains and losses, reserves, and assets *and expenses which are related to the insurance reinsured are generally treated as received, held, or incurred (as the case may be) by the reinsurer instead of the initial insurer.*

S. Rep. No. 291, *supra* p. 14 note 8, at 38-39 (emphasis added).

The meaning of these statements is clear: Congress intended an indemnity reinsurer to be treated for tax purposes as a direct writer. The Committee Report observes that a policy reinsured under a modified coinsurance contract is to be treated "in the same manner as" a policy reinsured under a conventional coinsurance contract for Federal income tax purposes. *Id.*, at 39. And how is a reinsurer treated under a conventional coinsurance contract? The reinsurer "is treated substantially in the manner he would be if he had issued the insurance policy (or part thereof) directly." *Id.*, at 38-39. Amici submit that the reinsurer can be treated in substantially the same manner as the direct writer only if, like the direct writer, the reinsurer can deduct the initial expenses of issuing its insurance policy. If Congress had intended that an indemnity reinsurer treat its initial expenses in a fundamentally different manner than the direct writer treats its initial expenses, Congress would have so provided. Congress enacted no rule providing for such different treatment, however. To the contrary, as is discussed in the next section, Congress specifically provided that ceding commissions are currently deductible.

B. *Section 809(c)(1) Expressly Allows a Deduction for Indemnity Reinsurance Ceding Commissions*

Given Congress' logical conclusion that the ceding commission paid by an indemnity reinsurer should be afforded the same treatment as the initial expenses of a direct writer, it is not surprising that Congress specifically provided for the current deduction of ceding commissions.[9] Section 809(c)(1) provides that the gross premium income of a life insurance company (Colonial American, in this case) is reduced by "return premiums, and premiums and other consideration arising out of reinsurance ceded" (hereafter referred to as simply "return premiums"). Consistent with the legislative history of section 809(c)(1),[10] the Treasury regulations state:

> The term "return premiums" means amounts returned or credited which are fixed by contract and do not depend on the experience of the company or the discretion of the management. Thus, such term

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[9] By treating one type of insurance (indemnity reinsurance) the same as another type of insurance (direct writing), Congress adhered to the basic principle of tax parity between similarly situated taxpayers. Tax parity is a principle which this Court has expressly recognized as a significant factor in determining whether an expense should be capitalized or expensed. *See Commissioner v. Idaho Power Co.*, 418 U.S. 1, 14 (1974); *see also Iowa-Des Moines Nat'l Bank v. Commissioner*, 592 F.2d 433, 436 (8th Cir. 1979) (citing tax parity in support of allowing a current deduction); *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775, 784 (2d Cir. 1973) (citing tax parity in support of allowing a current deduction). To have allowed a direct writer to deduct currently the initial expenses it incurs in issuing its insurance contracts, while denying such a deduction to an indemnity reinsurer for the initial expenses it incurs in issuing its indemnity reinsurance contracts, would have sanctioned disparate tax treatment between taxpayers who are engaged in the same activity: the issuance of insurance policies. Congress rejected this treatment in enacting the 1959 Act, just as this Court refused to countenance similarly disparate treatment in *Idaho Power*.

[10] S. Rep. No. 291, *supra* p. 14 note 8, at 54; H.R. Rep. No. 34, *supra* p. 14 note 8, at 29-30.

> includes amounts refunded due to policy cancellations or erroneously computed premiums. Furthermore, amounts of *premiums or other consideration returned to another life insurance company in respect of reinsurance ceded* shall be included in return premiums.

Treas. Reg. § 1.809-4(a)(1)(ii) (emphasis added). The regulations further provide that "reinsurance ceded" includes indemnity reinsurance transactions, but does not include (for reasons previously explained) assumption reinsurance transactions. *See* Treas. Reg. § 1.809-4(a)(1)(iii).[11]

Section 809(c)(1) and the regulations thereunder thus expressly state that amounts of premiums or other consideration returned to another life insurance company (Transport, in this case) in respect of an indemnity reinsurance transaction are deductible from the gross premium income of the reinsurer (Colonial American).[12] Indemnity reinsurance ceding commissions are precisely that: part of the gross premium income of the reinsurer that is returned to another life insurance company—the direct writer. Consistent with this, the ceding commission constitutes ordinary income to the direct writer, thus effectively reversing prior deductions of initial expenses by the direct writer.

The Seventh Circuit Court of Appeals, and the Tax Court in a series of decisions dating back to 1982, have

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[11] The 1984 Act amended section 809(c)(1), redesignated as section 803(a)(1), to make specific reference to indemnity reinsurance. The legislative history states that the "use of the term 'indemnity reinsurance' in the bill, instead of 'reinsurance ceded' under present law, is not intended to be a substantive change from present law." S. Prt. No. 169, *supra*, p. 14 note 8, at 529.

[12] Technically, section 809(c)(1) reduces the reinsurer's gross premiums by the amount of the ceding commissions it pays. The effect is the same as a deduction. For ease of reference, the section 809(c)(1) reduction is referred to herein as a deduction.

squarely held, consistent with the legislative history of the 1959 Act, that section 809(c)(1) directs the reinsurer in an indemnity reinsurance transaction to reduce the gross amount of its premium income by the ceding commissions it pays. *See Merit Life*, 853 F.2d 1435; *Beneficial Life*, 79 T.C. 627; *Modern Sec. Life Ins. Co.*, 52 T.C.M. (CCH) 188; *Individual Life Assurance Co.*, 51 T.C.M. (CCH) 1028; *Colonial Am. Life Ins. Co.*, 51 T.C.M. (CCH) 1123; *Merit Life*, 52 T.C.M. (CCH) 658. As the Seventh Circuit Court of Appeals stated:

> The Tax Court's reasoning in *Beneficial Life* is supported by the explicit language in section 809(c)(1) and the applicable treasury regulations. Section 809(c)(1) provides that an insurance company's gross income equals "the gross amount of premiums and other consideration . . . less return premiums, and premiums and other consideration arising out of reinsurance ceded." . . . Under section 809(c)(1), "reinsurance ceded" includes commissions from indemnity reinsurance transactions but not from assumption reinsurance transactions.

Merit Life, 853 F.2d at 1439.

The Commissioner, however, has contended that section 809(c)(1)'s reduction of gross income by return premiums serves to reduce only the direct writer's premium income, and not that of the reinsurer. The term, the Commissioner has argued, refers only to amounts that do not truly belong to the direct writer but must be turned over to, or shared with, the reinsurer. *See Merit Life*, 853 F.2d at 1439.

The answer to this contention, in the words of the Seventh Circuit Court of Appeals, is that "[t]here is no provision . . . in section 809 or the applicable treasury regulations which even remotely suggests the Commissioner's interpretation or distinction." *Merit Life*,

853 F.2d at 1439. In fact, the legislative history of section 809(c)(1) recognized that amounts paid by the reinsurer to the ceding company would be reductions in the reinsurer's premium income under section 809(c)(1): "experience refunds paid by the reinsurer to the initial insurer *are treated as reductions in premium income of the reinsurer* and as 'other income' received by the initial insurer." S. Rep. No. 291, *supra* p. 14 note 8, at 39 (emphasis added). This language clearly shows that Congress viewed return premiums as including amounts returned by a reinsurer to the direct writer, and not as limited only to amounts paid by the direct writer to the reinsurer. In sum, section 809(c)(1) provides a clear and logical answer to the question of how to treat indemnity reinsurance ceding commissions—they are currently deductible.[13]

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[13] As discussed in the text, *supra* pp. 17-20, amici believe that ceding commissions are properly deductible under section 809(c)(1). The Seventh Circuit Court of Appeals noted that, alternatively, indemnity reinsurance ceding commissions could be deductible as ordinary and necessary business expenses under section 809(d)(12). (Section 809(d)(12) was redesignated as section 809(d)(11) for tax years beginning after 1976. Pub. L. No. 94-455, § 1901(a)(98), 90 Stat. 1525, 1781.) The Seventh Circuit Court of Appeals explained:

> Alternatively, Merit claims that ceding commissions are deductible under sections 162 and 809(d)(11) as one of many "other deductions" or ordinary business expenses. The Tax Court in *Beneficial Life* noted that ceding commissions in indemnity reinsurance transactions are analogous to currently deductible underwriting expenses of a direct insurer. 79 T.C. at 647. Those deductions are made pursuant to section 809(d)(11). Because we hold that ceding commissions are deductible from gross premiums under section 809(c)(1), we need not address Merit's alternative argument, although we agree with the Tax Court's analogy.

Merit Life, 853 F.2d at 1445 (footnote omitted).

Amici agree that this alternative analysis is valid. Ceding commissions represent recurring ordinary and necessary expenses of

III. The Commissioner Erroneously Equates Indemnity Reinsurance with Assumption Reinsurance

The Commissioner also argues that indemnity reinsurance ceding commissions must be capitalized because under assumption reinsurance agreements the consideration paid for the purchase of life insurance policies must be capitalized. *See* Brief for the Respondent on Petition for a Writ of Certiorari at 6-7, *Colonial Am. Life Ins. Co. v. Commissioner, cert. granted*, 57 U.S.L.W. 3394 (U.S. Dec. 5, 1988) (No. 88-396). The Commissioner simply fails to recognize that the fundamental differences between indemnity reinsurance and assumption reinsurance are directly relevant to the income tax treatment of indemnity reinsurance ceding commissions.

As discussed above, indemnity reinsurance is the issuance of insurance coverage by one insurance company to another. Assumption reinsurance is the sale of part or all of the insurance policies of one insurance company to another. The basic and important difference between the two transactions was recognized by Congress when it enacted the 1959 Act. Thus, sections 806(a), 809(c)(1) and (d)(7), and 820 all provides rules which distinguish between indemnity and assumption reinsurance transactions.[14]

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the insurance business. As noted above, *supra* pp. 4-6, indemnity reinsurance is an integral part of the day-to-day business of the insurance industry. Indemnity reinsurance expenses are thus appropriately treated as ordinary and necessary expenses, even though each and every insurance company may not engage in indemnity reinsurance on a daily basis. *See generally Deputy v. Du Pont*, 308 U.S. 488, 495 (1940); *see also Equitable Life Ins. Co. of Iowa v. Commissioner*, 36 T.C.M. (CCH) 1184 (1977) (an insurance company's expenses incurred in registering variable annuity contracts are currently deductible day-to-day expenses of producing and marketing a business product).

[14] In addition, section 817(e) (repealed as "deadwood" in 1976, Pub. L. No. 94-455, § 1901(a)(100), 90 Stat. 1525, 1781) provided that if a company reinsured all of its contracts of a particular type

Furthermore, the Commissioner's own regulations acknowledge the distinction between indemnity reinsurance and assumption reinsurance in the context of the treatment of ceding commissions. The Commissioner's regulations do not provide that a ceding commission paid under an indemnity reinsurance contract is to be capitalized and amortized. However, Treas. Reg. § 1.817-4(d)(ii)(B), recognizing that assumption reinsurance is the sale of insurance contracts, requires "any amount paid to the reinsured [in an assumption reinsurance transaction] for the purchase of such contracts" to be capitalized and amortized.

Treas. Reg. § 1.817-4(d)(ii)(B) was issued on December 13, 1962, only three years after Congress enacted the 1959 Act. *See* T.D. 6225, 1963-1 C.B. 78. The regulation gives effect to the congressional recognition that an assumption reinsurance transaction involves the sale of some or all of an insurance company's contracts. It is a contemporaneous acknowledgment by the Commissioner that, unlike the ceding commission under an indemnity reinsurance contract, the consideration paid by the reinsurer in an assumption reinsurance transaction is for the purchase of insurance contracts. Accordingly, Treas. Reg. § 1.817-4(d)(ii)(B) requires that assumption reinsurance consideration be capitalized and amortized.

In addition, unlike the Courts of Appeals for the Fifth and Eighth Circuits,[15] the Courts of Appeals for the Sev-

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during 1958 "through the assumption by another company . . . of all liabilities under such contracts," the transaction was to be treated as a sale of a capital asset. This rule applied only to assumption reinsurance, not to indemnity reinsurance. *See* Treas. Reg. § 1.817-4(d). (Treas. Reg. § 1.817-4(d) clarified that although an assumption reinsurance contract was treated as a sale, the gain was not to be given capital gain treatment.)

[15] *See Colonial Am. Life Ins. Co.*, 843 F.2d 201; *Prairie States Life Ins. Co. v. United States*, 828 F.2d 1222 (8th Cir. 1987); *Modern Am. Ins. Co. v. Commissioner*, 818 F.2d 1386 (8th Cir. 1987).

enth and Ninth Circuits, as well as the Tax Court, have properly recognized the important distinctions between assumption reinsurance and indemnity reinsurance with respect to the treatment of ceding commissions. *Merit Life*, 853 F.2d 1435; *Oxford Life*, 790 F.2d 1370; *Beneficial Life*, 79 T.C. 627. As the Court of Appeals for the Seventh Circuit stated:

> The Court of Appeals for the Ninth Circuit recently distinguished assumption reinsurance from indemnity reinsurance with respect to the tax treatment of ceding commissions. *Oxford Life Insurance Company v. United States*, 790 F.2d 1370 (9th Cir. 1986). Although that case involved assumption reinsurance, the court emphasized its holding by making the following comparison between both reinsurance transactions:
>
> > Assumption reinsurance transactions receive different treatment in the Tax Code from that accorded indemnity reinsurance transactions because of the transfer of assets. An assumption reinsurance transaction is treated as a sale of policies; an indemnity reinsurance transaction is the purchase of insurance protection [by] the reinsured. *Beneficial Life*, 79 T.C. at 645-46.
>
> *Merit Life*, 853 F.2d at 1442.

In short, Congress intended that assumption reinsurance be treated differently than indemnity reinsurance, and the Code and regulations so provide. Indemnity reinsurance, including its initial expenses (ceding commissions), is treated under the Code and regulations in the same manner as directly written insurance. Assumption reinsurance, on the other hand, consistent with its nature, is treated as the purchase of assets.

IV. The Current Deductibility of Indemnity Reinsurance Ceding Commissions Is Vital to the Life Insurance Industry

Since 1958, life insurance companies have treated indemnity reinsurance ceding commissions as currently de-

ductible expenses for Federal income tax purposes.[16] This is the treatment that has been required since 1951 by the National Association of Insurance Commissioners for state regulatory accounting purposes. As the Court in *Merit Life* stated:

> [T]he Supreme Court has expressed a preference for the accounting rules and procedures of the National Association of Insurance [Commissioners] ("NAIC"). The Court has interpreted 26 U.S.C. § 818(a) as providing that the tax liability for insurance companies is to be computed consistent with the NAIC's rules except where "accrual accounting indicate[s] a contrary result, . . ." *Commissioner v. Standard Life and Accident Insurance Company*, 433 U.S. 148, 159, 97 S.Ct. 2523, 2529, 53 L.Ed.2d 653 (1977). Because generally accepted accounting principles (accrual accounting) do not control the tax treatment for ceding commissions in indemnity transactions, we must consider the NAIC's rules. Both parties agree that Merit's current deduction of ceding commissions followed the accounting rules for life insurance companies established by the NAIC.

Merit Life, 853 F.2d at 1444 (footnote omitted). Capitalization of ceding commissions would deviate from these traditional and Congressionally sanctioned accounting practices.[17]

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[16] Prior to 1958, life insurance companies were taxed only on their investment income, and therefore the treatment of ceding commissions was not relevant to determining life insurance companies' taxable income.

[17] The Commissioner has asserted that allowing the deduction of ceding commissions paid by an indemnity reinsurer causes "a gross distortion of income by mismatching the future income to be derived by a reinsurer from the reinsured policies with the current cost incurred to acquire the rights to that income." Brief for the Respondent on Petition for a Writ of Certiorari at 6, *supra* p. 21. Here again, the Commissioner fails to recognize that indemnity reinsurance is simply the issuance of an insurance policy by one insurance company to another. It is quite common for an insurance company issuing a policy to incur underwriting losses in the early years of the

Moreover, capitalization of indemnity reinsurance ceding commissions would disadvantage those companies which need indemnity reinsurance to survive or to grow. As one commentator has noted, reinsurance "is the only means by which a small, new company can compete effectively in the market place with its larger and better established brothers." *See* Rohm, *supra* p. 6, at 100. The obvious result of requiring capitalization of ceding commissions by indemnity reinsurers would be to increase the costs of indemnity reinsurance to direct writers. This would disproportionately hurt small and growing companies which, because of relatively low retention limits, must use significantly larger amounts of indemnity reinsurance in order to compete with the larger, more established companies in insuring new risks. These small and growing companies would be forced to reflect the increased cost of indemnity reinsurance in the premiums they charge policyholders, putting them at a competitive disadvantage vis-a-vis those companies for whom indemnity reinsurance is less crucial.

The marketplace should determine the competitive balance within the life insurance industry, and Federal income taxation should not disturb adherence to sound insurance practices requiring the use of indemnity reinsurance. This is only possible if the tax system is neutral as between the insurance company that uses indemnity reinsurance and the insurance company that does not use indemnity reinsurance. Neutrality requires, among other things, tax parity between the direct insurer and the indemnity reinsurer with respect to the deductibility of initial expenses, including ceding commissions. Congress

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policy. This occurs because the currently deductible expenses incurred in issuing the policy exceed the initial premium payments received. This fact has been specifically recognized by Congress and it has not been viewed as causing a "gross distortion of income." *See* H.R. Rep. No. 34, *supra* p. 14 note 8, at 4; S. Rep. No. 291, *supra* p. 14 note 8, at 7; *Merit Life*, 853 F.2d at 1443.

recognized this in section 809(c)(1) by providing that indemnity reinsurance ceding commissions are deductible when incurred just as the initial expenses of the direct writer are deductible when incurred.

CONCLUSION

For the reasons set forth above, this Court should reverse the judgment of the United States Court of Appeals for the Fifth Circuit.

Respectfully submitted,

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